IN THE

Supreme Court of the United States

October Term, 1940

No. .....

ALAMITOS LAND COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION.

To avoid duplication, this brief is limited to argument, since the formal statements required by the rules appear *ante* as part of the petition.

ARGUMENT.

I.

The Receipt in 1932 Did Not Constitute Taxable Income in the Constitutional Sense.

Petitioner is a small corporation having an average annual income of around $60,000.

It brought suit against an oil lessee for several years back royalties and obtained a judgment in its favor for $522,895.11. Instead of permitting the defendant, Shell Oil Company, to put up a supersedeas bond, the court required Shell to pay the money to petitioner or suffer

a forfeiture of the lease. Shell paid the money to petitioner in 1932 but in doing so stated that it was under the duress of the judgment and that it expected to appeal and get it back.

Under the circumstances, petitioner in receiving the money did not treat it as its own but put it in a special bank account (with the approval of its associates in the litigation, who had a 35% interest therein), and kept it segregated throughout the litigation. On its books and returns petitioner treated the item as an amount in suspense subject to being returned. Its books also showed that Shepard-Pendleton, Ltd. had a substantial interest in the litigation, but petitioner did not turn over to Shepard-Pendleton their portion of the money, as neither considered that there had as yet been a "recovery" entitling Shepard-Pendleton to the fee.

The decision of the lower court was reversed and petitioner returned the money in 1935 with accretions. In 1938 it settled the litigation, receiving $100,000.00 and paying Shepard-Pendleton $25,000.00 and other attorneys associated in the case $2500.00.

In 1935 petitioner had a net income without regard to the litigated items of $51,498.18 and in 1938 its estimated net income without regard to the litigated items was $69,463.75.

Under the circumstances it cannot be said that in the long run petitioner realized any income out of the litigation excepting as to its portion of the $100,000 received in settlement in 1938. Petitioner is, of course, perfectly willing to pay tax on its portion of the $100,000 in whatever year it is proper to do so.

Mr. Justice Cardoza, in *United States v. Safety Car Heating and Lighting Company*, 297 U. S. 89, 99, said:

> "Income within the meaning of the Sixteenth Amendment is the fruit that is born of capital, not the potency of fruition. With few exceptions, if any, it is income as the word is known in the common speech of men. When it is that, it may be taxed, though it was in the making long before."

It may be safely asserted that if the facts in this case were stated to a thousand men on the street, hardly one of them would agree with the Government's contention that the receipt in 1932 was income to petitioner. In fact, they would be shocked, as are petitioner's stockholders and directors, at respondent's position.

This Court, in *Bowers v. Kerbaugh-Empire Company*, 271 U. S. 170, has recognized that although the annual accounting period is important, still in certain circumstances all the facts happening over a period of years must be taken into account in considering whether a taxpayer has received income in the constitutional sense.

In *Eisner v. Macomber*, 252 U. S. 189, 207, this Court defined income as:

> "* * * a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being 'derived'—that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal—that is, income derived from property. Nothing else answers the description."

It cannot be said that when petitioner received the money in 1932 the receipt under the circumstances of the case satisfied the conditions stated in the above definition.

The petitioner knew that it received the money under the very serious possibility that it would have to return it. It did not feel free to spend the money; did not feel free to pay the fees it had agreed to pay when there was a "recovery." It did not feel that the money had been severed or derived for its separate use, benefit or disposal.

If there were no legal limitations or restrictions upon petitioner's use of the money, there certainly was a moral and practical one.

Although the court below held that petitioner did not receive the money as trustee, it did show that, as soon as the judgment was reversed, petitioner's liability from the beginning was that of trustee, except as to disbursements out of the fund which had been legally made. Petitioner knew that if the judgment was reversed it would have the liability of a trustee and the Circuit Court's conclusion that petitioner did not receive it as a trustee is too technical and unsubstantial to overcome the fact that in the long run, petitioner did not receive any income from this litigation, excepting upon the settlement in 1938.

Petitioner received the money in 1932 under a very substantial moral and practical restriction and with the knowledge that if the judgment were reversed, a legal restriction would apply from the moment of receipt.

Under the circumstances of this case, the right to take a deduction in the year of restitution does not make the receipt in 1932 taxable income in the constitutional sense. While in form it might appear that the right to deduct

the item in dispute in the year of restitution would compensate for taxing it in the year of receipt, this is not so in the case at bar in truth and substance. This Court has held in *Eisner v. Macomber,* 252 U. S. 189, page 206, that in determining what is and what is not income, the question is to be decided according to truth and substance, without regard to form. As the Board properly said in the case at bar [Record 42]:

> "Where possible, tax cases should be decided on realities and not on abstract hypothesis."

The reality in the present case is that the petitioner would not be permitted to deduct more than a small portion of the amount paid in restitution and it is therefore merely an abstract hypothesis to say that it would be proper to tax it in the year of receipt, because the taxpayer would be permitted to deduct it in the year of restitution.

The equalization theory depended upon by the respondent does not stem from any holding of this Court in any decided case. It is based upon *obiter dictum* in the case of *North American Oil Consolidated v. Burnett,* 286 U. S. 417. As shown on pages 16-17 of the petition herein the Court in illustrating the point in issue used language applicable to facts not in the case then before it, and in doing so announced the equalization theory. The only holding in the *North American* case was that the income received by the taxpayer in 1917 and thereafter retained by it, was taxable in 1917.

It is only the holding of the Court that is binding in subsequent cases and not other language used therein.

As stated by this Court itself in *Cohens v. Virginia,* 19 U. S. 264, 399, the rule as to the effect of its former decision is as follows:

> "It is a maxim, not to be disregarded, that general expressions in every opinion are to be taken in connection with the case in which those expressions are used. If they go beyond the case, they may be respected, but ought not to control the judgment in a subsequent suit, when the very point is presented for decision. The reason for this maxim is obvious. The question actually before the court is investigated with care and considered in its full extent. Other principles which may serve to illustrate it are considered in their relation to the case decided, but their possible bearing on all other cases is seldom completely investigated."

The Supreme Court of the State of Missouri, in *State v. St. Louis,* 241 Mo. 231, 238, 145 S. W. 801, 803, has well stated the rule as follows:

> "There is a pronounced line of demarcation between what is said in an opinion and what is decided by it—between arguments, illustrations and references on one side and the judgment rendered on the other. The language used by the Judge in his opinion is to be interpreted in the light of the facts and issues held in judgment in the concrete case precisely as in every other human document."

Of course the *North American* case is authority for the proposition that when a taxpayer receives money in a certain year, which money has been conceded to be

taxable income in some year, it is taxable in the year in which it is received, especially when the taxpayer is on the cash basis, even though there is a continuing claim that the money did not belong to the taxpayer. But that holding was decided in relation to a case where the taxpayer was eventually permitted to keep the money and where the money was concededly income to it in some year.

The holding in that case is not applicable to or binding upon another case where the issues are different and the facts are different. In the case at bar, the main issue is whether the money received by petitioner in 1932 and eventually given up by it is income to petitioner in the constitutional sense at all. In the *North American* case it was conceded that the money was income to the taxpayer in some year and the only issue was the year in which it was taxable, as in that case the taxpayer was permitted to retain the money. Consequently, since the facts and issues in the *North American* case were different from the facts and issues in the case at bar, the decision in that case is not decisive of the issues in the case at bar.

This Court has never held an item in litigation to be taxable income to the taxpayer in the year in which it received it as a result of a lower court's decision when the taxpayer was required to return it. The affect of the absence of a decision along this line is stated in 15 *C. J.* 916 as follows:

> "It has been held that the absence of reported judgments and decisions sustaining an alleged liability

under a given state of facts raises a strong presumption that no such liability exists." *Western Union Telegraph Company v. Schriver,* 141 Fed. 538.

The principle announced by the *obiter dictum* in the *North American* case works out so inequitably that this Court and other courts have distinguished it in several cases where the taxpayer received money but was required to give it back in later years. In *Freuler v. Helvering,* 291 U. S. 35, the beneficiaries of a trust received more money in a certain year than they were entitled to under the trust indenture and the State court required them to return it. This Court held that they were taxable only on the amount that was actually distributable to them.

In *Commissioner v. Turney,* 82 Fed. (2d) 661, the taxpayer received bonuses for granting oil leases, but it appeared that by virtue of its lease and state statutes it would probably be required to pay over half of the money to the State of Texas. Because of the fact that the chances of its giving up the money were quite certain, the Court distinguished the *North American* case, holding that it was taxable only on that portion of the bonus to which it was clearly entitled.

In *Great Southern Life Insurance Company v. Commissioner,* 89 Fed. (2d) 54, the taxpayer received interest on bonds which bonds and interest it eventually had to pay over to the rightful owner after litigation concerning the ownership. Here again the Court distinguished the *North American* case as the taxpayer was actually required to give up the income item in dispute.

Underlying these decisions is the thought that an item temporarily received but eventually returned, is not income in the constitutional sense.

II.

If the Item in Litigation Was Income to Petitioner it Represented Additional Royalties for the Period From 1921 to 1930, and Since Petitioner Kept Its Books and Made Its Returns on the Accrual Basis Additional Royalties Were Income in the Years Earned—1921 to 1930.

Petitioner kept its books and filed its returns on the accrual basis as to royalty income and since this constituted its main income producing account, it determined the character in which the entire books and returns were kept and made.

Upon the accrual basis, the time of receipt is not important, but the important fact in determining when income is to be reported is when the right to it becomes definitely determined.

If it was not necessary in this case to await the outcome of the highest court to which the litigation could go before determining that the litigated item was income to the petitioner, then the additional royalties constituted income in the months in which the oil was produced, namely, during the period from 1921 to 1930 inclusive. If the royalties were due to petitioner at all, they were due by virtue of its contract or lease with Shell. The liability for the correct royalties existed from the execution of the lease and the production of oil. Merely the amount or method of computing the royalties was in question; consequently when the method was established, the liability for the exact amount related back to the year in which the oil was produced. Compare *Lichtenberger-Ferguson Company v. Welch,* 54 Fed. (2d) 570.

In a long line of cases, the Board of Tax Appeals and the courts have consistently held that railroad companies which kept their books on an accrual basis were required

by law to report as income compensation received from the United States for the period of Governmental control in the years when actually earned even though the amount was in controversy until actually settled by payment in later years. The theory underlying these decisions is that income should be taxed for the year in which actually earned and at the tax rate then provided by law. See *Illinois Terminal Company,* 5 B. T. A. 15; *Texas and Pacific Railway Company,* 9 B. T. A. 365; *New Orleans T. & M. Railway Company,* 6 B. T. A. 436; *St. Louis and Southwestern Railroad Company,* 24 B. T. A. 917; *Western Maryland Railroad Company,* 12 B. T. A. 889; *Continental Tie and Lumber Company v. U. S.,* 52 Fed. (2d) 1045; *Commissioner v. Brooklyn Union Gas Company,* 62 Fed. (2d) 505; *Helvering v. Gulf M. & N. Railroad Company,* 71 Fed. (2d) 953.

In other situations, the Board of Tax Appeals and the courts have held that money received in one year was taxable income in an earlier year on the accrual basis. See *C. C. Harris Oil Company,* 13 B. T. A. 937; *Thomas D. Taylor,* 13 B. T. A. 1107, affirmed 51 Fed. (2d) 915, certiorari denied, rehearing denied; *John B. Ford,* 19 B. T. A 1143, affirmed 51 Fed. (2d) 206, certiorari denied, 284 U. S. 666; *Percy K. Hexter,* 8 B. T. A. 888.

The idea underlying the above cases is that the right existed from the earlier point of time, subsequent events merely confirming an already existing right.

If the payment in 1932 can be said to be income to petitioner at all, then since Shell agreed by the lease executed in 1921 to pay royalties to petitioner in amounts to be determined by each month's production, the correct amount of royalties constitutes taxable income to petitioner on the accrual basis in the year in which the oil was produced, namely, 1921 to 1930.

III.

If the Receipt in 1932 Constituted Taxable Income, Then Petitioner Should Only be Taxable on 65% Thereof as the Other 35% Belonged to Shepard-Pendleton.

Before the litigation with Shell was started, petitioner signed an agreement with Shepard-Pendleton, Ltd. to pay them 35% of any recovery obtained from Shell, through litigation or otherwise. Consequently, when petitioner received monies from Shell in 1932, 35% thereof was received by it as agent or trustee for Shepard-Pendleton and not as its own money.

This result should follow both under the law of California and under Federal decisions.

It is the law in California that where an executory contract is made between two parties, that one should have as compensation for services rendered to the other, a stipulated percentage of the proceeds of the judgment to be recovered for the other, the contract operates as an equitable assignment *pro tanto*. *Hoffman v. Vallejo,* 45 Cal. 564; *Luco v. DeToro,* 91 Cal. 405, 27 Pac. 1082; *Elliott v. Leopold Mining Company,* 53 Cal. 355. To the same effect, generally, see *Wooster v. Trowbridge,* 120 Fed. 667; *Hawk v. Ament,* 28 Ill. App. 390; *Briband v. Candler,* 166 Mich. 49, 131 N. W. 129; *Bent v. Lipcomb,* 45 W. Va. 183, 31 S. E. 908; *Curtis v. Metropolitan Street Railway Company,* 118 Mo. App. 34, 94 S. W. 762; *Texas C. R. Co. v. Andrews,* 28 Tex. Civil Appeals 477, 67 S. W. 923; *Coughlin v. N. Y. C. and H. R. R. Company,* 71 N. Y. 443, 2 A. L. R. 454.

As a result of the agreement between petitioner and Shepard-Pendleton and the law of California, Shepard-Pendleton had a 35% interest in the litigation and if any income was realized at all in 1932, 35% thereof was income to Shepard-Pendleton and only 65% to petitioner.

This same result would follow under several Federal decisions. For example, *Commissioner v. Turney,* 82 Fed. (2d) 661; *Stoner v. Commissioner,* 79 Fed. (2d) 75. In the *Turney* case the taxpayer received an oil bonus which, by virtue of its lease and state statutes, it was bound to turn over to the State of Texas. The court held that it was taxable only on the portion which it was entitled to keep and was not taxable on the portion which was required to but had not been turned over to the State of Texas. In the *Stoner* case the taxpayer was the principal stockholder of a corporation and he agreed to sell all of the stock of the company, with the further provision that he was to retain a $50,000.00 tax reserve fund for two years. If at the end of that time any of it was left after paying taxes of the corporation, he would turn it over to all the stockholders. The court held that he was not taxable in the year of sale on any portion of the $50,000.00 as he held it for the benefit of all the stockholders.

The court below, in the case at bar, was therefore in error in not in any event excluding 35% of the receipt from Shell from petitioner's taxable income in the year 1932. See *Lowery v. Helvering,* 70 Fed. (2d) 713; *Byrnes v. Commissioner,* 89 Fed. (2d) 243; *Commissioner v. Ross,* 83 Fed. (2d) 18; *Helvering v. Sestree,* 72 Fed.

(2d) 67; *Hall v. Burnet,* 54 Fed. (2d) 443; *Nelson v. Flagman,* 56 Fed. (2d) 121.

To further illustrate the great injustice which might be done by following the *obiter dictum* in the *North American* case rather than the holding of that case, the Commissioner wishes to include 100% of the receipt from Shell in 1932 as taxable income of petitioner but does not wish to allow as an exclusion or as a deduction the 35% which was due to be paid to Shepard-Pendleton upon a recovery. In other words, the Commissioner says that the receipt was such a recovery as to constitute taxable income to petitioner but was not such a recovery as to constitute a liability of petitioner to pay Shepard-Pendleton, because petitioner would not be required to pay Shepard-Pendleton unless and until the state court eventually held that petitioner was entitled as between it and Shell to keep the money.

Any language in a Supreme Court decision which makes such an inequitable proposition technically tenable and arguable should be re-examined by this Court.

IV.

Interest on the Shell Fund Should Follow the Fund, and Since the Fund Was Not Taxable to Petitioner Upon Its Receipt in 1932, the Interest on the Fund Should Not Be Taxable to Petitioner in 1932 or 1933.

This point is self explanatory and will not be further argued here.

The court below did not discuss this point but impliedly approved the respondent's inclusion of the interest on the fund accrued in 1932 and 1933 in petitioner's taxable income for those years.

Since petitioner did not receive any income in the constitutional sense from the receipt from Shell in 1932, and since petitioner was required to return to Shell the interest on the impounded fund, petitioner received no taxable income on account of that interest.

V.

The Question Involved Is of Such Importance That a Writ of Certiorari Should be Granted.

If this Court should consider that the decision of the lower court is not in conflict with one or more of the Supreme Court cases cited herein, or with the Circuit Court cases cited herein, then the Circuit Court of Appeals has decided an important question of Federal law which has not been but should be settled by this Court.

It is apparent from the respondent's position in this case, both with respect to the receipt of the money in 1932 and the treatment of the 35% payable to Shepard-Pendleton, Ltd. that the *obiter dictum* in the *North American* case makes it possible for the Commissioner to propose and the courts to hold taxpayers taxable on items which do not constitute income in the constitutional sense.

Inasmuch as the decisions of the Circuit Court of Appeals are in most cases final, it is apparent that great injustice may be done to many taxpayers unless the confusion created by the *obiter dictum* is corrected.

It is submitted that the Commissioner and the court below were over-impressed by the language in the Supreme Court decision, even though that language is *obiter dictum* and these lower tribunals should again be instructed on the effect of the former decisions of this Court.

The result which the respondent seeks in this case and which the Circuit Court has allowed is shocking to the

stockholders and directors of petitioner and will be shocking to all others who read the Circuit Court's decision. Unless the great injustice resulting from the Circuit Court's decision is corrected by this Court, great injury will be done to the confidence of the taxpaying public in the attitude of the Commissioner and of the courts.

Furthermore, as shown in the petition, a great number of cases involve items in litigation and practically all of them cite or refer to or attempt to distinguish the decision in the *North American* case and particularly the *obiter dictum* therein, and unless the limitation to which the holding in that case may be applied is determined by this Court, much future litigation will ensue and probably much continued inequity, hardship and injustice on taxpayers will follow.

It is therefore respectfully submitted that the petition should be granted.

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August 8, 1940.

Due service of the within Petition and Brief is hereby acknowledged this.....day of August, A. D. 1940.

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Counsel for Respondent.

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